Appendix E4: Treasury Management Strategy 2023/24

1. Introduction

1.1. Treasury management is the management of The Council's cash flows, borrowing and investments, and the associated risks. The Council has [borrowed and/or invested] substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to The Council's prudent financial management.

1.2. Treasury risk management at The Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2021 Edition (the CIPFA Code) which requires The Council to approve a treasury management strategy before the start of each financial year. This report fulfils The Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

1.3. The Council is required to operate a balanced budget, which broadly means that monies received during the year will meet payments expenditure. The function of treasury management is to ensure that the Council's capital programme and corporate investment plans are adequately funded, and the cashflow is adequately planned, with cash being available when it is needed to discharge the Council's legal obligations and deliver Council services. Surplus monies are invested to obtain an optimal return, while ensuring security of capital and liquidity.

1.4. Investments held for service purposes or for commercial profit are considered in a different report, the Investment Strategy, which can be found at **Appendix E3**.

2. Economic Outlook

2.1. 2022 forecasts changed dramatically when Vladimir Putin's troops crossed the Ukrainian border on 24th February. While the Ukraine war may eventually come to be seen as the fundamental moment of change for the post-Cold War world, its nearer term impact on economies and markets has been far clearer: as this review of the major themes shows, it has dictated much – but by no means all – of how they performed in 2022, and its continuation will play a big role in how 2023 shapes up as well" By Neil Shearing, Group Chief Economist Published on 12th December 2022". Appendix A examines the economic external context in which was a determinant for this strategy.

3. Interest rate forecast

3.1. The Council's treasury management adviser Arlingclose forecasts that Bank Rate will continue to rise in 2023 as the Bank of England attempts to subdue inflation which is significantly above its 2% target.

3.2. While interest rate expectations reduced during October and November 2022, multiple interest rate rises are still expected over the forecast horizon despite looming recession. Arlingclose expects Bank Rate to rise to 4.25% by June 2023 under its central case, with the risks in the near- and medium-term to the upside should inflation not evolve as the Bank forecasts and remains persistently higher.

3.3. Yields are expected to remain broadly at current levels over the medium-term, with 5-,10- and 20-year gilt yields expected to average around 3.6%, 3.7%, and 3.9%

respectively over the 3-year period to December 2025. The risks for short, medium and longer-term yields are judged to be broadly balanced over the forecast horizon. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events. A more detailed economic and interest rate forecast provided by Arlingclose is in **Appendix B**.

3.4. For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate/yield of 3%, and that new long-term loans will be borrowed at an average rate of 4.5%.

4. Local Context

4.1. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while balance sheet resources are the underlying sums available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

4.2. On 31st December 2022, The Council held £265.606m of borrowing and £80.2m of treasury investments. Forecast changes in these sums are shown in the balance sheet analysis in **table 1** below.

Table 1: Balance sheet summary and forecast

	31.3.22 Actual £m	31.3.23 Estimate £m	31.3.24 Forecast £m	31.3.25 Forecast £m	31.3.26 Forecast £m
General Fund CFR	183.508	204.470	229.353	270.290	313.017
HRA CFR	84.024	79.427	74.973	70.101	64.829
PFI CFR	442.261	484.871	501.345	544.640	584.388
Capital financing requirement	**709.793**	**768.768**	**805.671**	**885.032**	**962.234**
Less: Other debt liabilities*	(84.024)	(79.427)	(74.973)	(70.101)	(64.829)
Loans CFR	**625.769**	**689.341**	**730.698**	**814.931**	**897.405**
Less: External borrowing**	(274.274)	(265.606)	(242.545)	(213.877)	(195.209)
Internal (over) borrowing	**351.495**	**423.735**	**488.153**	**601.054**	**702.196**
Less: Balance sheet resources	(476.995)	(391.335)	(394.853)	(392.654)	(394.596)
(Treasury investments)/ New borrowing	**(125.500)**	**32.400**	**93.300**	**208.400**	**307.600**

* leases and PFI liabilities that form part of The Council's total debt.

** shows only loans to which The Council is committed and excludes optional refinancing.

4.3. The Council has an increasing CFR due to the capital programme and will therefore be required to borrow up to £642m over the forecast period.

4.4. CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that The Council's total debt should be lower than its highest forecast CFR over the next three years. The Council expects to comply with this recommendation during 2023/24.

5. Liability benchmark

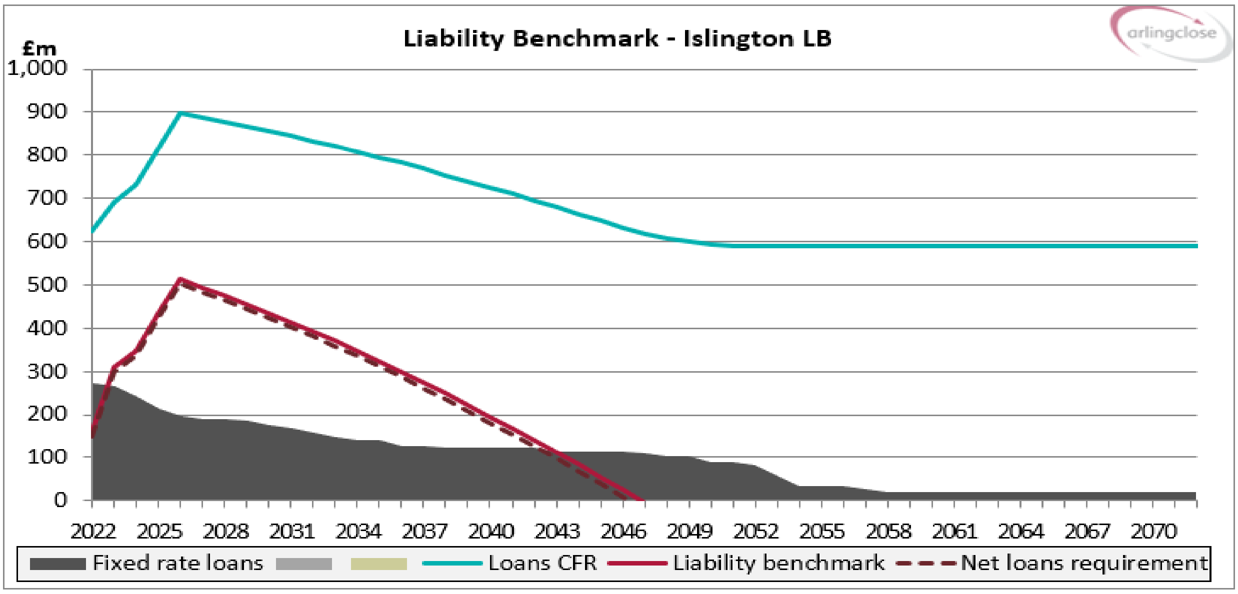
5.1. To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing (Table 2). This assumes the same forecasts as Table 1 above, but that cash and investment balances are kept to a minimum level of £10m at each year-end to maintain sufficient liquidity but minimise credit risk.

5.2. The liability benchmark is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

Table 2: Prudential Indicator

	31.3.22 Actual £m	**31.3.23 Estimate £m**	**31.3.24 Forecast £m**	**31.3.25 Forecast £m**	**31.3.26 Forecast £m**
Loans CFR	625.769	689.341	730.698	814.931	897.405
Less: Balance sheet resources	(476.995)	(391.335)	(394.853)	(392.654)	(394.596)
Net loans requirement	**148.774**	**298.006**	**335.845**	**422.277**	**502.809**
Plus: Liquidity allowance	10.000	10.000	10.000	10.000	10.000
Liability benchmark	**158.774**	**308.006**	**345.845**	**432.277**	**512.809**

5.3. Following on from the medium-term forecasts in **table 2** above, the long-term liability benchmark assumes capital expenditure funded by borrowing, minimum revenue provision on new capital expenditure based on a 25-year asset life and income, expenditure and reserves all increasing by inflation of 2.5% a year. This is shown in the chart below together with the maturity profile of The Council's existing borrowing. The indicator demonstrated that the Council's debt profile does not exceed the liability benchmarks:



5.5. The chart above shows how the optimum position determined by the benchmarks compares to the current portfolio commitments. Positive balances show the loans position compared to the Liability Benchmark and negative balances show Investments compared to the Investment Benchmark. Any areas of the chart where the current loan commitments are below the Liability Benchmark show the need for external borrowing. The Council must borrow up to that level to avoid the determined liquidity allowance from being insufficient. Anywhere on the chart that shows the existing commitments above the level of the Liability Benchmark shows an excess level of borrowing over the required position and is reflected in over benchmark investment positions.

5.6. As the net position has been derived, and the level of external borrowing determined (the maximum of existing commitments or Liability Benchmark), the consequential level of investments can be solved. Where there is excess borrowing, there is excess investments, over the level of liquidity required. Where borrowing is required, it will be determined as such a level to ensure the liquid investments do not fall below the specified level required.

6. Borrowing Strategy

6.1. The Council currently holds £265.606 million of loans, a decrease of £9.668 million on the previous year, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that The Council expects to borrow up to £32m in 2023/24. The Council may also borrow additional sums pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £608.8 million.

6.2. **Objectives**: The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should The Council's long-term plans change is a secondary objective.

6.3. **Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, The Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

6.4. By doing so, The Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of [internal / short-term] borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist The Council with this 'cost of carry' and breakeven analysis. Its output may determine whether The Council borrows additional sums at long-term fixed rates in 2023/24 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

6.5. The Council has previously raised the majority of its long-term borrowing from the PWLB but will consider long-term loans from other sources including banks, pension funds and local authorities, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; The Council intends to avoid this activity in order to retain its access to PWLB loans.

6.6. Alternatively, The Council may arrange forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

Sources of borrowing

6.7. The approved sources of long-term and short-term borrowing are:

- HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except our local Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

Other sources of debt finance

6.8. In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback

Municipal Bonds Agency

6.9. UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It issues bonds on the capital markets and lends the proceeds to local authorities. This is a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

LOBOs

6.10. Islington Council holds no LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the council has the option either to accept the new rate or to repay the loan at no additional cost.

Short-term and variable rate loans

6.11. These loans leave The Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below. Financial derivatives may be used to manage this interest rate risk (see section below).

Debt rescheduling

6.12. The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk. The recent rise in interest rates means that more favourable debt rescheduling opportunities should arise than in previous years.

7. Treasury Investment Strategy

7.1. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, The Council's treasury investment balance has ranged between £100m and £150m. The levels are expected to be reduced in the forthcoming year to a range of £70million to £100 million, which is in line with the strategy.

Objectives

7.2. The CIPFA Code requires The Council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

7.3. The Council aims to be a responsible investor and will consider environmental, social and governance (ESG) issues when investing.

Strategy

7.4. As demonstrated by the liability benchmark above, The Council expects to be a long-term investor and treasury investments will therefore include both short-term low risk instruments to manage day-to-day cash flows and longer-term instruments where limited additional risk is accepted in return for higher investment income to support local public services.

7.5. Where appropriate: The CIPFA Code does not permit local authorities to both borrow and invest long-term for cash flow management. But the Council may make long-term investments for treasury risk management purposes, including to manage interest rate risk by investing sums borrowed in advance for the capital programme; to manage inflation risk by investing usable reserves in instruments whose value rises with inflation; and to manage price risk by adding diversification to the investment portfolio.

ESG policy:

7.6. Environmental, social and governance (ESG) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore The Council's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. When investing in banks and funds, The Council will prioritise banks that are signatories to the UN Principles for Responsible Banking and funds operated by managers that are signatories to the UN Principles for Responsible Investment, the Net Zero Asset Managers Alliance and/or the UK Stewardship Code.

Business models

7.7. Under the IFRS 9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost. Alternatively, if you have a business model of achieving value by selling investments, and/or a combination of collecting and selling, describe this and clarify which investments are held in which business model.

Approved counterparties

7.8. The Council may invest its surplus funds with any of the counterparty types in **Table 3** below, subject to the limits shown.

Table 3: Treasury investment counterparties and limits

Sector	Time limit	Counterparty limit	Sector limit
The UK Government	50 years	Unlimited	n/a
Local authorities & other government entities	25 years	£15m	Unlimited
Secured investments *	25 years	£15m	Unlimited
Banks (unsecured) *	13 months	£5m	Unlimited
Building societies (unsecured) *	13 months	£5m	£10m
Registered providers (unsecured) *	5 years	£5m	£25m
Money market funds *	n/a	£10m	Unlimited
Strategic pooled funds	n/a	£10m	£50m
Real estate investment trusts	n/a	£10m	£25m
Other investments *	5 years	£5m	£10m

Minimum credit rating

7.9. The Council has reviewed the way it formulates its counterparty criteria. The lending list criteria is devised from the use of rating agencies which will include) as well as other factors. The main sovereign states whose banks are to be included are Australia, Canada, Finland, France, Denmark, Germany, Netherlands, Switzerland and the US. These countries and the Banks within them have been selected after analysis and careful monitoring of:

- Credit Ratings (minimum long-term A+ minimum short term F1).
- Credit Default Swaps.
- GDP; Net Debt as a Percentage of GDP.
- Sovereign Support Mechanisms / potential support from a well-resourced parent institution.
- Share Price.

The Council has restricted its investment activity to the following institutions while conditions in the financial sector are monitored for stability and cashflow positions are averaging around £100m.

- The Debt Management Agency Deposit Facility (The rates of interest from the DMADF are below equivalent money market rates. However, the returns are an acceptable trade-off for the guarantee that the Council's capital is secure).
- AAA-rated Money Market Funds with a Constant Net Asset Value (CNAV) and Variable Net Asset Value (VNAV).
- Deposits with other local authorities.
- Business reserve accounts and term deposits. These have been primarily restricted to UK institutions that are rated at least A+ long term.

Government

7.10. Loans to, and bonds and bills issued or guaranteed by, national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 50 years.

Secured investments

7.11. Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.

Banks and building societies (unsecured)

7.12. Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

Registered providers (unsecured)

7.13. Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

Money market funds

7.14. Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, The Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

Strategic pooled funds

7.15. Bond, equity and property funds that offer enhanced returns over the longer term but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting The Council's investment objectives will be monitored regularly.

Real estate investment trusts

7.16. Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

Other investments

7.17. This category covers treasury investments not listed above, for example unsecured corporate bonds and company loans. Non-bank companies cannot be bailed-in but can become insolvent placing the Council's investment at risk.

Operational bank accounts

7.18. The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25bn. These are not classed as investments but are still subject to the risk of a bank failure, and balances will therefore be kept below £30m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25bn are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk assessment and credit ratings

7.19. Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. The credit rating agencies in current use are listed in the Treasury Management Practices document. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,

- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

7.20. Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as “negative watch”) so that it may fall below the approved rating criteria, then only investments that can be withdrawn [on the next working day] will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other information on the security of investments

7.21. The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from The Council’s treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

7.22. When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2020, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest The Council’s cash balances, then the surplus will be deposited with the UK Government, or with other local authorities. This will cause investment returns to fall but will protect the principal sum invested.

Investment limits

7.23. To limit risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £15m. A group of entities under the same ownership will be treated as a single organisation for limit purposes.

7.24. Limits are also placed on fund managers, investments in brokers’ nominee accounts and foreign countries as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country since the risk is diversified over many countries.

Liquidity management

7.25. The Council uses purpose-built cash flow forecasting software [or describe other methods] to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of The Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to The Council’s medium-term financial plan and cash flow forecast.

8. Treasury Management Indicators

8.1. The Council measures and manages its exposures to treasury management risks using the following indicators.

Security

8.2. The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average [credit rating / credit score] of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	Target
Portfolio average credit	*A+*

Liquidity

8.3. The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling one-month period, without additional borrowing.

Liquidity risk indicator	Target
Total cash available within 3 months	£25m

Interest rate exposures

8.4. This indicator is set to control The Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£2,600
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£1,600

8.5. The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at new market rates.

Maturity structure of borrowing

8.6. This indicator is set to control The Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	30%	0%
12 months and within 24 months	35%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	40%	0%
10 years and within 20 years	50%	0%
20 years and above	100%	40%

8.7. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Long-term treasury management investments

8.8. The purpose of this indicator is to control The Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The prudential limits on the long-term treasury management investments will be:

Price risk indicator	2023/24	2024/25	2025/26	No fixed date
Limit on principal invested beyond year end	**£30m**	**£20m**	**£20m**	**£30m**

Authorised Limit

8.9. The authorised borrowing limit for the Authority is £608.8m.

Related Matters

8.10. The CIPFA Code requires The Council to include the following in its treasury management strategy.

9. Financial derivatives

9.1. Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

9.2. The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that The Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

9.3. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria, assessed using the appropriate credit rating for derivative exposures. An allowance for credit risk calculated using the methodology in the Treasury Management Practices document will count against the counterparty credit limit and the relevant foreign country limit.

9.4. In line with the CIPFA Code, The Council will seek external advice and will consider that advice before entering into financial derivatives to ensure that it fully understands the implications.

Housing Revenue Account

9.5. On 1st April 2012, The Council notionally split each of its existing long-term loans into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/ credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative.

Markets in Financial Instruments Directive

9.6. The Council has opted up to professional client status with its providers of financial services, including [advisers, banks, brokers and fund managers], allowing it access to a greater range of services but with the greater regulatory protections afforded to individuals and small companies. Given the size and range of The Council's treasury management activities, the Corporate Director of Resources believes this to be the most appropriate status.

Financial Implications

9.7. The budget for investment income in 2023/24 is £1 million. The budget for debt interest paid in 2023/24 is £13 million. If actual levels of investments and borrowing, or actual interest rates, differ from those forecasts, performance against budget will be correspondingly different.

10. <u>Other Options Considered</u>

10.1. The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Corporate Director of Resources having consulted the Executive Member for Finance and Performance, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

<u>Appendix A – Arlingclose Economic External Context – December 2022</u>

The ongoing impact on the UK from the war in Ukraine, together with higher inflation, higher interest rates, uncertain government policy, and a deteriorating economic outlook, will be major influences on The Council's treasury management strategy for 2023/24.

The Bank of England (BoE) increased Bank Rate by 0.5% to 3.5% in December 2022. This followed a 0.75% rise in November which was the largest single rate hike since 1989 and the ninth successive rise since December 2021. The December decision was voted for by a 6-3 majority of the Monetary Policy Committee (MPC), with two dissenters voting for a no-change at 3% and one for a larger rise of 0.75%

The November quarterly Monetary Policy Report (MPR) forecast a prolonged but shallow recession in the UK with CPI inflation remaining elevated at over 10% in the near-term. While the projected peak of inflation is lower than in the August report, due in part to the government's support package for household energy costs, inflation is expected remain higher for longer over the forecast horizon and the economic outlook remains weak, with unemployment projected to start rising.

The UK economy contracted by 0.3% between July and September 2022 according to the Office for National Statistics, and the BoE forecasts Gross Domestic Product (GDP) will decline 0.75% in the second half of the calendar year due to the squeeze on household income from higher energy costs and goods prices. Growth is then expected to continue to fall throughout 2023 and the first half of 2024.

CPI inflation is expected to peak at around 11% in the last calendar quarter of 2022 and then fall sharply to 1.4%, below the 2% target, in two years' time and to 0% in three years' time if Bank Rate follows the path implied by financial markets with a peak of 5.25%. However, the BoE has stated it considers this path to be too high, suggesting that the peak in interest rates will be lower, reducing the risk of inflation falling too far below target. Market rates have fallen since the time of the November MPR.

The labour market remains tight for now, with the most recent statistics showing the unemployment rate was 3.7%. Earnings were up strongly in nominal terms by 6.1% for both total pay and regular pay but factoring in inflation means real total pay was -2.7%. Looking forward, the MPR shows the labour market weakening in response to the deteriorating outlook for growth, leading to the unemployment rate rising to around 6.5% in 2025.

Interest rates have also been rising sharply in the US, with the Federal Reserve increasing the range on its key interest rate by 0.5% in December 2022 to 4.25%-4.5%. This rise follows four successive 0.75% rise in a pace of tightening that has seen rates increase from 0.25%-0.50% in March 2022. Annual inflation has been slowing in the US but remains above 7%. GDP grew at an annualised rate of 3.2% (revised up from 2.9%) between July and September 2022, a better-than-expected rise, but with official interest rates expected to rise even further in the coming months, a recession in the region is widely expected at some point during 2023.

Inflation rose consistently in the Euro Zone since the start of the year, hitting a peak annual rate of 10.6% in October 2022, before declining to 10.1% in November. Economic growth has been weakening with an upwardly revised expansion of 0.3% (from 0.2%) in the three months to September 2022. As with the UK and US, the European Central Bank has been on an interest rate tightening cycle, pushing up its three key interest rates by 0.50% in December, following two consecutive 0.75% rises, taking its main refinancing rate to 2.5% and deposit facility rate to 2.0%.

Credit outlook:

Credit default swap (CDS) prices have generally followed an upward trend throughout 2022, indicating higher credit risk. They have been boosted by the war in Ukraine, increasing economic and political uncertainty and a weaker global and UK outlook, but remain well below the levels seen at the beginning of the Covid-19 pandemic.

CDS price volatility was higher in 2022 compared to 2021 and the divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities has emerged once again.

The weakening economic picture during 2022 led the credit rating agencies to reflect this in their assessment of the outlook for the UK sovereign as well as several local authorities and financial institutions, revising them from to negative from stable.

There are competing tensions in the banking sector which could impact bank balance sheet strength going forward. The weakening economic outlook and likely recessions in many regions increase the possibility of a deterioration in the quality of banks' assets, while higher interest rates provide a boost to net income and profitability.

However, the institutions on our adviser Arlingclose's counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

Appendix B – Arlingclose Economic & Interest Rate Forecast – December 2022

Underlying assumptions:

- The influence of the mini-budget on rates and yields continues to wane following the more responsible approach shown by the new incumbents of Downing Street.
- Volatility in global markets continues, however, as investors seek the extent to which central banks are willing to tighten policy, as evidence of recessionary conditions builds. Investors have been more willing to price in the downturn in growth, easing financial conditions, to the displeasure of policymakers. This raises the risk that central banks will incur a policy error by tightening too much.
- The UK economy is already experiencing recessionary conditions and recent GDP and PMI data suggests the economy entered a technical recession in Q3 2022. The resilience shown by the economy has been surprising, despite the downturn in business activity and household

spending. Lower demand should bear down on business pricing power – recent data suggests the UK has passed peak inflation.

- The lagged effect of the sharp tightening of monetary policy, and the lingering effects of the mini-budget on the housing market, widespread strike action, alongside high inflation, will continue to put pressure on household disposable income and wealth. The short- to medium-term outlook for the UK economy remains bleak.
- Demand for labour appears to be ebbing, but not quickly enough in the official data for most MPC policymakers. The labour market remains the bright spot in the economy and persisting employment strength may support activity, although there is a feeling of borrowed time. The MPC focus is on nominal wage growth, despite the huge real term pay cuts being experienced by the vast majority. Bank Rate will remain relatively high(er) until both inflation and wage growth declines.
- Global bond yields remain volatile as investors price in recessions even as central bankers push back on expectations for rate cuts in 2023. The US labour market remains tight, and the Fed wants to see persistently higher policy rates, but the lagged effects of past hikes will depress activity more significantly to test the Fed's resolve.
- While the BoE appears to be somewhat more dovish given the weak outlook for the UK economy, the ECB seems to harbour (worryingly) few doubts about the short-term direction of policy. Gilt yields will be broadly supported by both significant new bond supply and global rates expectations due to hawkish central bankers, offsetting the effects of declining inflation and growth.

Forecast:

- The MPC raised Bank Rate by 50bps to 3.5% in December as expected, with signs that some members believe that 3% is restrictive enough. However, a majority of members think further increases in Bank Rate might be required. Arlingclose continues to expect Bank Rate to peak at 4.25%, with further 25bps rises February, March and May 2023.
- The MPC will cut rates in the medium term to stimulate a stuttering UK economy but will be reluctant to do so until wage growth eases. We see rate cuts in the first half of 2024.
- Arlingclose expects gilt yields to remain broadly steady over the medium term, although with continued volatility across shorter time periods.
- Gilt yields face pressures to both sides from hawkish US/EZ central bank policy on one hand to the weak global economic outlook on the other. BoE bond sales and high government borrowing will provide further underlying support for yields.

	Current	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25	1.25
Arlingclose Central Case	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.25	3.25	3.25	3.25
Downside risk	0.00	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00
3-month money market rate													
Upside risk	0.00	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25	1.25
Arlingclose Central Case	3.00	4.40	4.40	4.40	4.35	4.30	4.25	4.00	3.75	3.50	3.40	3.40	3.40
Downside risk	0.00	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00
5yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.43	3.60	3.80	3.80	3.80	3.70	3.60	3.50	3.40	3.30	3.30	3.30	3.30
Downside risk	0.00	0.80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.47	3.50	3.60	3.60	3.60	3.60	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Downside risk	0.00	0.80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
20yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.86	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85
Downside risk	0.00	0.80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
50yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.46	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60
Downside risk	0.00	0.80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

PWLB Standard Rate (Maturity Loans) = Gilt yield + 1.00%
PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
UKIB Rate (Maturity Loans) = Gilt yield + 0.60%

Appendix C – Counterparty List

	Fitch L/T	Fitch S/T	Moodys L/T	Moodys S/T	S & P L/T	S & P S/T	Sovereign Rating - F/M/S&P	Maximum Limit - £	Maximum Term	LBI	Arlingclose Current Advice	Lending at 31/12/2022
UK Banks												
Barclays	A+	F1	A1	P-1	A	A-1	AA-/Aa3/AAu	15,000,000	100 days	**Council Bankers from Mar 2015 - overnight liquidity only**	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Handelsbanken plc	AA	F1+	NR	NR	AA-	A-1+	AA+/+Aa2/AA-	15,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
HSBC	AA-	F1+	A1	P-1	A+	A-1	AA-/Aa3/AAu	15,000,000	6 Months	Limit to 6 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Lloyds Bank PLC / Bank of Scotland	A+	F1	A1	P-1	A+	A-1	AA-/Aa3/AAu	15,000,000	6 Months	Limit to 6 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
RBS	A+	F1	A1	(P)P-1	A	A-1	AA-/Aa3/AAu	15,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
NATWEST PLC	A+	F1	A1	P-1	A	**A-2**	AA-/Aa3/AAu	15,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Santander UK	A+	F1	A1	P-1	A	A-1	AA-/Aa3/AAu	15,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	10,000,000
Standard Chartered	A+	F1	A1	P-1	A+	A-1	AA-/Aa3/AAu	15,000,000	6 Months	Limit to 6 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
UK Building Societies												
Coventry	A	F1	A2	P-1			AA-/Aa3/AAu	NONE			Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Leeds	A	F1	A3	P-2			AA-/Aa3/AAu	NONE			Limit to 100 days / %5 Deposits & CDs/ 10% Secured	

	Fitch L/T	Fitch S/T	Moodys L/T	Moodys S/T	S & P L/T	S & P S/T	Sovereign Rating - F/M/S &P	Maximum Limit - £	Maximum Term	LBI	Arlingclose Current Advice	Lending at 31/12/2022
Nationwide	A+	F1	A1	P-1	A-1	A+	AA-/Aa3/AAu	15,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Yorkshire	A	F1	A3	P-2	NR	NR	AA-/Aa3/AAu	NONE			Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Non UK Banks												
Australia												
Australia & NZ Banking Group	A+	F1	Aa3	P-1	AA-	A-1+	AAA/Aaa/AAAu	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Commonwealth Bank of Australia	A+	F1	Aa3	P-1	AA-	A-1+	AAA/Aaa/AAAu	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
National Australia Bank	A+	F1	Aa3	P-1	AA-	A-1+	AAA/Aaa/AAAu	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Westpac Banking Corporation	A+	F1	Aa3	P-1	AA-	A-1+	AAA/Aaa/AAAu	10,000,000	100 days	Limit to 3 Months		
Canada												
Bank of Montreal	AA	F1+	Aa2	P-1	A+	A-1+	AA+/Aa1/AA+	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Bank of Nova Scotia	AA	F1+	Aa2	P-1	A+	A-1	AA+/Aa1/AA+	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Canadian Imperial Bank of Commerce	AA	F1+	Aa2	P-1	A+	A-1	AA+/Aa1/AA+	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	

	Fitch L/T	Fitch S/T	Moodys L/T	Moodys S/T	S & P L/T	S & P S/T	Sovereign Rating - F/M/S &P	Maximum Limit - £	Maximum Term	LBI	Arlingclose Current Advice	Lending at 31/12/2022
Royal Bank of Canada	AA+	F1+	Aa2	P-1	AA-	A-1+	AA+/ Aa1/ AA+	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Toronto-Dominion Bank	AA	F1+u	Aaf1	P-1	AA-	A-1+	AA+/ Aa1/ AA+	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Finland												
Nordea Bank ABP	AA	F1+	Aa3	P-1	AA-	A-1+	AA+/ Aa1/ AA+	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Germany												
DZ BANK AG DEUTSCHE ZENTRAL-	AA	F1+	Aa2	P-1	A+	A-1	AAA/ Aaau/ AAAu	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
LANDESBANK BADEN-WUERTTEMBERG	A	F1	Aa3	P-1	NR	NR	AAA/ Aaau/ AAAu	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Netherlands												
Cooperative Rabobank	AA-	F1+	Aa2	P-1	AA-	A-1	AAA/ Aaa/ AAA	10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	
Other												
UK Local Authorities (except for Slough Borough Council, Thurrock Council and Croydon)							AA- /Aa3/ AAu	15,000,000(per authority)	24 Months +		Limit to 24 Months - WEF 11/12/2018	45,200,000

	Fitch L/T	Fitch S/T	Moodys L/T	Moodys S/T	S & P L/T	S & P S/T	Sovereign Rating - F/M/S &P	Maximum Limit - £	Maximum Term	LBI	Arlingclose Current Advice	Lending at 31/12/2022
Supra-National Bonds (EIB)	AA+	F1+	Aa1	P-1	AAA	A-1+	N/A	Unlimited	25 years		Limit to 25 years 10% of portfolio -	
Transport For London (Suspended)	A+	F1+	A=	P-2	Baaa 1	A-1	AA-/Aa3/AAu	NONE			Up to 24 months - Limit 10% of portfolio (Approx £15m)	
UK DMADF	NR	NR	NR	NR	NR	NR	AA-/Aa3/AAu	Unlimited	50 years		Unlimited	15,000,000
MMFs (Fidelity suspended)		AAA mmf		Aaa-mf		AAA m		10,000,000	100 days	Limit to 3 Months	Limit to 100 days / %5 Deposits & CDs/ 10% Secured	10,000,000
LCR Finance PLC	AA-	NR	Aa3	NR	AA	NR	AA-/Aa3/AAu	15,000,000	10 years		OK - Limit to 10% of Fund Size (approx £ 15M)	
Network Rail Infrastructure Finance PLC	AA-	NR	Aa3	P-1	AA	NR	AA-/Aa3/AAu	15,000,000	10 years		OK - Limit to 10% of Fund Size (approx £ 15M)	
UK Government	AA-	NR	Aa3	NR	Aau	A-1+u	AA-/Aa3/AAu	Unlimited	50 years		Unlimited	
Wellcome Trust Finance PLC	NR	NR	Aaa	NR	AAA	NR	AA-/Aa3/AAu	10,000,000	20 years		OK - Limit to 5% of Fund Size (approx £10M)	
										TOTAL FUNDS INVESTED		**80,200,000**